Taxation on the Transfer of Farm Business Assets to Family Members

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Factsheet

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Every farm business, whether a sole proprietorship, partnership or corporation, will some day change ownership. This Factsheet deals with the tax implications of transferring farm assets to family members and the options available to minimize tax.

Prior to any major transfer of assets it is critical to consult a tax advisor. Do this well in advance, since the best tax results often require a two or three year planning window.

For information on the sale of farm assets outside the family see OMAFRA Factsheet *Taxation on the Sale of Farm Assets*, Order No. 08-047. For an overview of the succession planning process refer to the *Farm Succession Planning Guide*, Publication 70.

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SECTION 1: NON-TAX ISSUES OF A FARM TRANSFER

COMPONENTS OF CHANGE IN A FARM TRANSFER

A change in farm ownership is often a significant transition, with two significant components. One is the "procedural" dimension dealing with the how, when and what to transfer. This could include tax implications, credit arrangements, business organization, operating agreements, insurance, wills and legal documentation.

The second is the "psychological" dimension. This involves the family and relationship dynamics that often determine the ultimate success of a family farm business transfer. Components include the meshing of personal and business goals, the willingness to let go of ownership, the selection and training of a successor(s) and communication among family members.

TRANSITION MANAGER AND TEAM WORK

A farm transfer and succession plan can be complex. Given the multitude of components an advisory team is essential. A *business management* advisor can help the family:

- clarify goals
- identify alternatives
- assist with business and financial planning
- understand the potential tax and legal ramifications

The *accounting* and *legal* advisors can fine tune the alternatives and implement the decisions made by the family.

The most successful farm business transfers usually reveal a strong *transition manager* who acts like a team captain. Ideally the farm business owner would fill this role, providing the leadership, attitude and patience needed for a successful transition.

IMPORTANT CONSIDERATIONS

Clarifying Goals

Before formulating any meaningful transfer plans, it is crucial to clearly identify family and business goals and communicate these to all farm family members. Some farm families find this easy, others benefit from professional advice. A current business advisor may be able to help with this step or direct you to another professional.

Ministry of Agriculture, Food and Rural Affairs

Ontario

Farm Business Viability

Since the business must be profitable — or have profit potential — for a farm transfer to occur, determine the financial condition of the business early in the transfer planning process.

Financial Needs of Parents

If parents have other assets or sources of income they could be more generous in both a transfer price and credit terms. However, this would not be the case if the parents have considerable cash needs.

Successor Training

A successful farm business transition is more likely where the successor(s) have management experience. This is often obtained through owning assets, revenue-sharing arrangements, or where progressive management responsibility is given over time.

SECTION 2 — METHODS OF TRANSFERRING FARM BUSINESS ASSETS

There are several methods of transferring farm business assets.

1. BEQUEST

Farming and other assets can be transferred by bequest through an individual's will. If certain criteria are met, most farm assets can transfer from parent to child upon death free of immediate tax. In the absence of a transfer plan the will can be a "contingency" plan. Unfortunately some families use the will as their primary transfer vehicle, creating uncertainty for the farming children. It also prevents farming children from developing their own succession plans with their children.

2. GIFTS[1]

While farming children would prefer this method, not all farmers can afford to make such a gift. Many farmers do partially gift their farms by selling to their children at below fair market value or by gifting certain assets. In either case there is no tax on a gift of farming assets. The gift of a non-farming asset to a child however may be taxable. Placing a child on title to a property is also a considered a gift to the child and a disposition or transfer of the property for the parent.

One exception is the gifting of inventory, which is fully taxable in the year it is transferred.

Gifts to minor children or spouses can result in property income from the asset being attributed back to the giver. These rules are covered in Section 6.

3. SALE

The sale of farm assets to family members at fair market value (FMV) is the same as selling to a non-family member. Normal tax calculations are made. Good planning is essential to create the desired tax results.

4. COMBINATION — BEQUEST, GIFT, SALE

Most transfers involve a combination of bequest, gift and sale. Parents often desire to sell farm assets at the lowest price they can afford in order to defer the maximum amount of tax. A bequest can then be used to distribute other assets to non-farming children on the parents' death.

SECTION 3 — INCOME TAX ROLLOVERS AND DEFERRALS

The *Income Tax Act* allows farmers to defer tax on the transfer of farming assets to a spouse or child. This is called a "rollover". Spouses can also receive non-farming assets by way of rollovers. On a rollover of farming assets to a child any price between zero and fair market value can be chosen, although for tax calculation purposes the tax cost is used as the lowest value. The rollover provides significant flexibility in choosing appropriate transfer values. Even though the $750,000 capital gains exemption may be available, it is desirable to maintain the eligibility for the rollover.

The term "child" has an extended meaning and includes a daughter, son, grandchild, great grandchild, son-in-law, daughter-in-law, adopted child, step child or their spouses who are resident in Canada. In addition a person who, at any time before aged 19, was wholly dependent on the taxpayer for support and of whom the taxpayer had, at that time, in law or in fact, the custody and control is considered a child.[2]

Rollovers of property to a child must meet the requirements outlined below.

REQUIREMENTS FOR TAX DEFERRAL ROLLOVERS FROM PARENT TO CHILD

To qualify for the rollover to a child the eligible property must, before the transfer, be principally used in a farming business in which the individual, their spouse, common-law partner or their child or parent, was actively involved on a regular and continuous basis.[3] In 2006 the words "immediately before" were

inserted into Section 70 of the *Act* that made the provision more difficult to meet. However Canada Revenue Agency (CRA) has indicated they intend to revert to the phrase "before the transfer".

According to the CRA "principally used" means the property must have been farmed for more than 50 per cent of the time of ownership by the transferor. See OMAFRA Factsheet *Taxation on the Sale of Farm Assets*, Order No. 08-047 for a more detailed explanation of the term "principally used".

Other Considerations

- The eligible property may be owned either solely or jointly.
- The transfer may take place while the taxpayer is alive, or at the time of death.
- Rollovers are allowed on successive transfers such as a rollover of property to a spouse and then to a child while alive or upon death. The assets eligible for a rollover could also pass to a spousal trust and then to a named child.
- Eligible property transferred from an estate must vest indefeasibly with a child, which means it must transfer to the beneficiary within 36 months of death with no strings attached. A longer period may be granted if special circumstances warrant it.
- On the death of a child an election is allowed to transfer the property to a parent on a rollover basis.[4]

Pitfalls that could negate rollovers

- Rental of assets to persons other than children or spouses for more than 50 per cent of the ownership period negates rollover and deferral.
- A "tainted" spousal trust can negate a rollover. This can occur if the spousal trust breaks certain rules. For example if a spousal trust makes payments to someone other than the spouse it would no longer be a valid spousal trust.
- An obvious beneficiary of a spousal trust must be named. For example, a will that leaves land to a named beneficiary if they outlive the spouse, but to a different beneficiary if the first beneficiary should pre-decease the spouse, can negate a rollover.

SECTION 4 — CAPITAL GAINS

TAXATION OF CAPITAL GAINS

Fifty per cent of a capital gain is tax free. The other half is subject to regular tax. This portion, called the taxable capital gain, is added to all other income in the year the gain occurs. Any allowable capital losses can be deducted from the taxable capital gain. If the capital gain occurs on a corporately owned asset, 50 per cent of the gain is tax free and is allocated to the Capital Dividend Account. Dividends from this account are received tax free by the shareholder. The other half of the gain is taxable in the corporation.

Some tax credits may be affected in the current year and/or the year after reporting a capital gain, even though the capital gains exemption is used. This is because the taxable capital gain is reported on your tax return and affects the calculations of tax credits even though the exemption is used to reduce the tax paid. The increased net income may result in the claw back of some benefits such as the Old Age Security and Child Tax benefits in the current year and may also reduce them in the year following the capital gain.

$750,000 CAPITAL GAINS EXEMPTION[5]

In 2007, the Capital Gains Exemption was increased to $750,000 from $500,000 for dispositions occurring after March 18, 2007. The $750,000 Capital Gains Exemption is available to individuals on the sale of qualified farm property. Anyone who used the entire $100,000 general exemption when it was eliminated in 1994 has $650,000 remaining. The exemption is also available to partners in a partnership, since capital gains in a partnership flows directly to the partners who can then use the exemption. The capital gains exemption is not available to corporations; however, the shares of a family farm corporation are eligible for the exemption.

Qualified farm property[6] includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota

Equipment and machinery are not eligible for the capital gains exemption. However, in a partnership or corporation, the value of equipment and inventory is included in the corporate shares or partnership interest.

Qualified farm property must meet the following definitions:[7]

- Property must be principally used in farming by one of the following qualified users:
  - the individual
  - the spouse, child or parent of the individual
  - or by a family farm partnership or corporation of the individual, spouse, child or parent

and

- Property purchased prior to June 18, 1987:
  - must be used in principally farming in the year of sale or
  - have been principally used in farming for any 5 years during its ownership

- Property purchased after June 17, 1987:
  - must be owned for 24 months prior to the sale

and

  - in at least two years, the gross farm revenue of one of the qualified users who is actively engaged in farming the property must exceed income from all other sources

or

  - the property was principally used by a family farm partnership or corporation in a two-year period, during which time the individual, spouse, child, parent or partnership of which they are a member, was actively involved in the farming business.

In all cases, the qualifying individuals — whether farming as a sole proprietorship, a partnership or corporation — must be actively engaged in management and/or the day-to-day activities of the business.

Definition of "Principally Used"

Similar to the requirements under the rollover provision, the CRA defines "principally used" to mean "more than 50 per cent" from either a time or usage perspective.

1994 $100,000 Capital Gains Election

In 1994, the $100,000 capital gains exemption for general property was eliminated. At that time, individuals were allowed to elect to increase the adjusted cost base of their property by up to $100,000, but not exceeding the February 1994 value. If you made such an election on your qualified farm property, you are deemed to have disposed of the property and reacquired it in 1994. As a result you must now meet the more difficult post-June 17, 1987, rules for qualified farm property on a future sale.

Splitting Capital Gains Between Spouses

If both spouses contributed to the purchase of property, they can split the gains to reduce taxes. Although both may be on title, it is the contribution toward the purchase that is the most critical. Generally, the capital gains from assets that are transferred to a spouse by way of gift attribute back to the spouse who transferred the asset. However the timing of the transfer is important.

Spouses added to title on or before December 31, 1971, would likely be able to split the capital gain. However, if they were added after that date, attribution rules would prevent splitting. See Section 6 for an explanation of the spousal attribution rules.

If the property is the asset of a spousal partnership, the capital gains will flow through to each partner based on their percentage ownership.

CALCULATING YOUR CAPITAL GAIN

Adjusted Cost Base

To calculate a capital gain or loss, you must know the adjusted cost base (ACB). This is the amount deducted from the selling price to determine a capital gain or loss. For property obtained before 1972, the ACB is the greater of original cost or the December 31, 1971, value. If obtained after 1971, the ACB is the purchase price plus costs. The cost base of land is adjusted by adding any non-depreciable capital improvements, legal and realty fees to the adjusted cost base. The ACB of buildings is increased by any capital improvements or additions, beyond just the normal maintenance and repair. Table 1, *Calculating Capital Gain*, shows an example of a capital gain calculation.

Table 1. Calculating capital gain

Purchased 1975	$150,000
Legal fees	1,000
Sold in 2008	600,000
Legal fees	2,000
Real estate fees	20,000
ACB = $150,000 + $1,000 + $2,000 + $20,000 =	$173,000
Capital gain: $600,000 – $173,000	**$427,000**

Table 2. Within Family Transfer of Assets

	Transfer to Spouse		Transfer to Child	
Type of Asset	**While Alive (*inter vivos*)**	**On Death (*testamentary*)**	**While Alive (*inter vivos*)**	**On Death (*testamentary*)**
Farm Inventory – Cash Basis	No rollover – transfer at FMV *ITA ss. 69(1)*	Rollover allowed to any beneficiary at cost of inventory	No rollover – transfer at FMV *ITA ss. 69(1)*	Rollover allowed to any beneficiary at cost of inventory
Farm Inventory – Accrual Basis	Transfer at FMV but with potential smaller tax implications because of accrual filing	Rollover allowed to any beneficiary at cost of inventory	Transfer at FMV but with potential smaller tax implications because of accrual filing	Rollover allowed to any beneficiary at cost of inventory
Machinery and Equipment – Post 1971 (Part XI)	Transfer at UCC or FMV *ITA ss. 73(1) and 73(1.01)*	Automatic rollover at UCC Can elect to transfer at FMV *ITA ss. 70(6) and (6.2)*	Transfer at between ACB and FMV *ITA ss. 73(3) and 73(3.1)*	Automatic rollover at UCC Can elect to transfer between UCC and FMV. *ITA ss. 70(9) and 70(9.01)*
Buildings Post 1971 (Part XI)	Transfer at UCC or FMV *ITA ss. 73(1) and 73(1.01)*	Automatic rollover at UCC, election allowed to opt out of rollover and transfer at FMV *ITA ss. 70(6) and (6.2)*	Transfer at between ACB and FMV Less than ACB allowed *ITA ss. 73(3) and 73(3.1)*	Automatic rollover at UCC, election allowed to opt out of rollover and transfer at price between UCC and FMV. *ITA ss. 70(9) and 70(9.01)*
Part XVII pre 1972 Machinery, Equipment and Buildings	Can transfer and /or sell to spouse for use in business at cost, otherwise gift or transfer at FMV. No recapture	Rollover at UCC	No tax deferral available – must transfer at either $0 or FMV. If gifted ($0) then child receives it at FMV. No recapture	No rollover available – they pass to child at FMV No recapture but capital gain possible
Quota (Eligible Capital Property)	Rollover allowed at 4/3 cumulative eligible capital (CEC) No option to elect at any other value *ITA ss. 24(2)*	Automatic rollover at 4/3 cumulative eligible capital (CEC) No option to elect at any other value *ITA ss. 24(2)*	Transfer between ACB and FMV but normally between "4/3 CEC + 1971 Value" and FMV. *ITA ss. 73(3) and 73(3.1)*	Child or any other beneficiary deemed to acquire quota at 4/3 of taxpayers cumulative eligible capital (CEC) No income or loss is triggered *ITA ss. 70(5.1)*
Land	Rollover at ACB allowed Can elect to transfer at FMV *ITA ss. 73(1) and 73(1.01)*	Automatic rollover at ACB Can elect to transfer at FMV *ITA ss. 70(6) and (6.2)*	Rollover at ACB allowed Can transfer at any value between ACB and FMV *ITA ss. 73(3) and 73(3.1)*	Rollover at ACB allowed Can elect to transfer at any value between ACB and FMV *ITA ss. 70(9) and 70(9.01)*
House	Transfer at $0 or FMV (NOT in between if not a farming property) If the house is used in the farming business rollover rules would apply	Transfer at $0 or FMV (NOT in between if not a farming property) If the house is used in the farming business rollover rules would apply	Transfer at $0 or FMV (NOT in between if not a farming property) If the house is used in the farming business rollover rules would apply	Transfer at $0 or FMV (NOT in between if not a farming property) If the house is used in the farming business rollover rules would apply
Farm Corporation Shares and Partnership Interest	Rollover at ACB allowed Can elect to transfer at FMV *ITA ss. 73(1) and 73(1.01)*	Automatic rollover at ACB Can elect to transfer at FMV *ITA ss. 70(6) and (6.2)*	Rollover at ACB allowed Can transfer at any value between ACB and FMV *ITA ss. 73(4) and 73(4.1)*	Rollover at ACB allowed Can elect to transfers at any value between ACB and FMV *ITA ss. 70(9.2) and 70(9.21)*

SECTION 5 — DETERMINING A SALE PRICE ON A TRANSFER

In the *Act* and this Factsheet it is stated that certain eligible assets can be transferred to a child at values anywhere between their tax cost and fair market value (FMV). While these values are used to calculate tax implications, it does not prevent an asset being transferred below the tax cost, as in the case of a gift. For depreciable assets the tax cost is the undepreciated capital cost (UCC), and for land and other capital property it is the adjusted cost base (ACB). These values are used to calculate taxes.

Example:

A parent sells a piece of eligible land to a child for $50,000. The fair market value (FMV) of the property was $200,000 and it was purchased for $100,000 (ACB). What would be the outcome?

The parent would have proceeds of $50,000 – with no capital gain and no tax to pay because that amount is below the ACB. The child will pay $50,000 but for future tax calculation he or she is deemed to have acquired the land at the ACB of the parent or $100,000. The same result occurs if the parent gifted the property to the child.

If the selling price falls between the ACB and FMV part of the tax liability is incurred and part is deferred.

Utilizing the Capital Gains Exemption

The $750,000 capital gains exemption makes it attractive for both parties to sell as close to FMV as possible. This provides the parent with tax-free proceeds (except for possible application of the alternative minimum tax (see Section 9)) and the child an asset with a higher ACB. To help finance the business and reduce debt charges, the parent can charge a low interest rate. The parent may even forgive a mortgage in his or her will. Holding a mortgage from a child also qualifies as a reserve and can spread capital gains over 10 years, if needed, to avoid minimum tax.

Table 2, *Within Family Transfer of Assets*, on previous page, provides a quick summary of the transfer options.

SECTION 6 — TRANSFERING ASSETS TO A SPOUSE OR COMMON LAW PARTNER

In general terms capital property,[8] which includes most farm assets such as land, buildings, machinery, shares and partnership interests, can be transferred to a spouse or common law partner on a rollover basis that is fully tax deferred. This can occur before or after death. There is also an option to elect out of the rollover and allow the asset transfer at its FMV. This can be done on an asset-by-asset basis.

On a transfer to a spouse or common law partner there is no opportunity to set the price between the ACB and the FMV as there is on a transfer to a child.

Transfers of inventory and quota are the exceptions to the general rules. Inventory can be transferred on a rollover basis on death to any beneficiary however it must be transferred at FMV while alive.

Quota is considered eligible capital property and a rollover to a spouse while alive or on death is allowed as long as certain conditions are met. The conditions are:

- that the spouse must acquire all of the quota and
- the spouse must carry on the business.[9]

However, there is no opportunity to elect to have the quota transfer take place at FMV.

ATTRIBUTION RULES[10]

Assets transferred to a spouse can result in income, such as interest or capital gains being attributed back to the transferring spouse. If for example a property was rolled over to a spouse and the spouse subsequently sold the property and incurred a capital gain, the capital gain would be attributed to the spouse who transferred the property and they would have to include the taxable capital gain in their income. Business income on the other hand is not attributed back to the transferring spouse.

In order to prevent these attribution rules from applying three conditions must be met:

1. The property must be sold for FMV to the other spouse and consideration received for it.

2. If debt is part of the consideration received then a commercial rate of interest must be charged and always paid by Jan 30th of each year.

3. The transferring spouse must elect out of the rollover provisions, which will trigger any capital gains and will then be taxable in the hands of the transferring spouse.

Attribution rules can also apply to transfers to minor children (income but not capital gains) and loans to non-arms length persons.

SECTION 7 — TRANSFERING ASSETS TO A CHILD

This section deals with the tax implications of transferring various types of assets to a child. Any differences between a transfer while alive and at death are highlighted for the various types of assets.

INVENTORY — LIVESTOCK[11], CROPS AND SUPPLIES

Transfer While Alive

The tax treatment of inventory is significantly different depending on when it is transferred to a child and how the farm files taxes.

- If the transfer takes place while the parent is alive it must transfer at FMV and this amount included in the parents income.

- If the farm files income tax on the accrual basis the inventory value included in income will be much lower than cash basis filers. Cash basis farmers should consider strategies before transferring.

Since cash-basis farmers only report income when received, one approach is for the parent to hold an appropriately structured promissory note containing restrictions on payment, such as payable 366 days after demand. A note without restrictions as to when payment can be demanded represents "absolute payment" of the debt, and in such a case CRA could claim that payment has been received in full.

This approach allows inventory payments to be spread over a number of years. The payments would be farm income, eligible for CPP and RRSP contributions.

- Other options include using a basic herd deduction (in the case of older livestock operations) and the use of optional or mandatory inventory adjustments taken in previous years.

- Transfers can also be timed for when inventory of crops and supplies are at their lowest.

- If the parent and child plan to operate in a partnership or corporation the parent could roll the inventory into the corporation or partnership and subsequently transfer shares or a partnership interest to the child. The timing of this type of transaction is important. If no other assets are transferred and the transfer to the child occurs soon after the inventory is moved, CRA could view it as a tax avoidance transaction and disallow it.

Transfers on Death

On death inventory can be rolled over to any beneficiary on a tax-deferred basis. When the inventory is sold it becomes income to the beneficiary. Farmers who file income tax on the cash basis have three options for reporting inventory and accounts receivables (these are called "rights and things"[12]) on death:

- report the income as part of the terminal tax return
- file a special separate return that allows for the deduction of personal credits[13] or
- elect to have the rights and things rollover to any beneficiary where it is reported as income to the beneficiary when the item is sold or receivable is collected.[14]

Table 3. Alternative Transfer Prices for Part XI Assets

Today's FMV ($)	Various Family Sale Prices ($)	Cost ($)	UCC ($)	Deemed Proceeds to Parent(s) & Cost to Child ($)	Capital Gain ($)	Re-capture ($)
25,000[1]	25,000	20,000	12,000	25,000[1]	5,000	8,000
25,000	18,000	20,000	12,000	18,000	0	6,000
25,000	12,000[2]	20,000	12,000	12,000[2]	0	0
25,000	0	20,000	12,000	12,000	0	0

1 Assume a building and that the parent used the capital gains exemption. The child's cost for CCA purposed will be reduced to $20,000 due to parent's use of the capital gains exemption. See *Income Tax Act* Paragraph 13(7)(e).

2 Because most parents want to avoid recapture, the UCC is a common sale price.

BUILDINGS, MACHINERY AND EQUIPMENT — PURCHASED AFTER 1971 (PART XI DEPRECIABLE ASSETS)

Transfers While Alive

Buildings, machinery and equipment are usually transferred at or below their tax cost or in tax terminology their *undepreciated capital cost* (UCC). This is because values above UCC may generate "recapture". *Recapture* is the repayment of previously used deductions of capital cost allowance.

These assets can be transferred for any value between UCC and FMV. *Table 3* above illustrates the results of some alternative family sale prices.

If the equipment has appreciated above the purchase value then it could also generate a capital gain, which may result in the following adjustments:

- If the parent uses the capital gains exemption the amount the child can use for future CCA deduction is reduced by the amount of the capital gains exemption used.

- There is a further reduction of CCA on half of the untaxed portion of the capital gain on any gain that the parent does claim a capital gains exemption on.[15]

These adjustments do not apply on a transfer at death.

Transfers on Death

On death, buildings, machinery and equipment automatically rollover to beneficiaries at their

undepreciated capital cost (UCC). This defers any recapture or capital gains. Similar to the transfer while alive an election can be made to elect out of this automatic rollover and select a price between UCC and FMV. *Table 4* gives some examples.

Table 4. Part XI Assets to a Child

	Rollover ($)	Election ($)
FMV – Class 8 Asset	60,000	60,000
UCC	30,000	30,000
Rollover Value	30,000	Not used
Election Value	not used	50,000
Recapture	0	20,000

BUILDINGS, MACHINERY AND EQUIPMENT — PURCHASED BEFORE 1972 (PART XVII DEPRECIABLE ASSETS)

Transfers While Alive

There is no tax deferral for buildings, machinery and equipment purchased before 1972. They must transfer at their fair market value regardless of the sale price. The deemed proceeds for the parent is the fair market value while the cost to the child is the amount paid. However if the parent transfers these assets as an outright gift, the child is considered to have paid the FMV.

Most depreciable assets, such as equipment, have decreased in value and disappeared since 1971, creating no tax concerns; but good buildings may have accrued capital gains since 1971. There is no recapture on the transfer of these assets. The rule of thumb is to transfer at either zero or FMV.

Transfers on Death

On death there is no rollover for pre 1972 assets. They pass to a child at FMV. Such assets are not subject to recapture of capital cost allowance, but can incur a capital gain. Any capital gains on pre 1972 buildings would be eligible for the $750,000 capital gain exemption.

PRINCIPAL RESIDENCE

Transfers While Alive

Generally a principal residence is deemed to transfer at FMV regardless of the sale price to the child. This is usually not a concern since a principal residence is exempt from capital gains. However since the cost to the child is the price they paid, it is to their advantage to have the transfer take place at either zero or FMV as *Table 5* below illustrates.

Table 5. Alternative Transfer Prices for Personal Residence

1971 Value ($)	Today's FMV ($)	Various Transfer Prices ($)	Deemed Proceeds to Parent ($)	Deemed Cost to Child ($)
25,000	95,000	95,000	95,000	95,000
25,[illegible]	95,000	55,000	95,000	55,000
25,000	95,000	0	95,000	95,000

A principal residence may also be eligible for the rollover and capital gains exemption if it is used principally in the farming business as described below.[16]

Corporate Ownership of Residence

A residence owned by a corporation is considered to be used principally for farming business if more than 50 per cent of its use is to accommodate persons, or their dependants, actively employed in the farming business. Furthermore, the residence must be provided to these persons in their capacity as employees rather than as shareholders, and the residence must be part of the business operation in that it provides accommodation for employees whose services may be required at virtually any time by virtue of the nature of the farming operations.

Life and Remainder Interest

Obtain professional advise if an option being considered is to maintain a life interest in the farm house and transfer the remainder interest in that house to a child. This strategy can have unintended consequences for the child who receives the remainder interest.

Remainder Interest Transfer to Child

On the death of the parent the child will have to report in their income the accrued capital gain that has occurred since their received the remainder interest. However they will not have the benefit of the principal residence exemption since the parents' house is not a principal residence to the child. This could be a significant amount if 10 or 15 years have passed.

QUOTA – ELIGIBLE CAPITAL PROPERTY

The tax rules for buying and selling quota are complex. What follows is a review of how tax is calculated on the sale of quota, followed by a discussion of the implications of a transfer within the family.

Depreciating (Amortizing) Quota and the Cumulative Eligible Capital (CEC) account

Quota is a type of property called eligible capital property. When quota is purchased three quarters (75 per cent) it is added to an account called the cumulative eligible capital account or CEC account. This account is used to determine the annual allowance for depreciation and to keep track of the quota that you buy and sell.

Quota is depreciable at a rate of 7 per cent annually. The other one quarter of your quota purchase is non-depreciable. If you bought quota worth $100,000, $75,000 (75 per cent) would be added to your cumulative eligible capital account, and depreciated at a rate of 7 per cent per year, on a declining basis.

Selling Quota

The sale of quota can generate two types of taxable income:

1. the recapture of depreciation previously taken
2. the increase in value over the original purchase price. While this is often called a capital gain, technically only "capital property" can generate a "capital gain."

Recapture

Recapture on quota sales is similar to that of buildings, machinery and equipment. Recapture occurs when the cumulative eligible capital account falls below zero; a portion of the sale is recaptured and added to your income.

Increase in Value of Quota

If the quota has appreciated, the increase in value can be reported in as either: (1) business income that is eligible for the capital gain exemption and as such is not subject to Alternate Minimum Tax (AMT); or (2) an election can be filed that deems the increase in the value of quota to be a capital gain similar to that on land or other non-depreciable capital property.[17] The use of the election results in the following:

1. AMT may be payable
2. a capital gains reserve can be created for proceeds of the sale that are not due until a future year or fiscal period
3. capital losses can be used to offset any capital gains on the quota

The election can only be used where there is a recognized gains and not losses. A calculation can determine if the election would be advantageous or not. *Table 6* shows an example of a quota sale.

Table 6. Example of Quota Sale

Information needed for the Calculation	
1971 value	$20,000
CEC account balance	$30,000
Depreciation	
Pre '988	$8,000
Post 1988	$12,000
Calculation	
Gross Sale Value	$350,000
Deduct 1971 value ($20,000)	$330,000
Taxable portion (75%)	$247,500
Deduct CEC ($30,000)	$217,500
Less Recapture (total depreciation)	$20,000
Subtotal	$197,500
Less 50% of pre-1988 depreciation	$4,000
	= $193,500
Inclusion Rate Adjustment[1] 2/3 adjustment results in additional farming income of:	$129,000
Total Income to Report	**$149,000**

[1] Quota sold in Fiscal Period Ending after Oct. 18, 2000 the inclusion rate is 50%, down from 75%, which means an adjustment of 2/3

Quota Calculation Details

In the example shown in *Table 6*, $20,000 of recapture is added to the farm income, plus the farming income as a result of the increase in the value of the quota.

The $4,000 pre-1988 depreciation adjustment occurs because in 1988, the capital gains inclusion rate was raised to 75 per cent from 50 per cent. Eligible Capital Property accounts were adjusted by 50 per cent to account for the change in the amount of quota that was now eligible to be depreciated.

Depreciation taken before 1988 however, was not recalculated, so an adjustment is required at the time of sale to reduce the income from the quota sale by 1/2 the pre-1988 depreciation. This is depreciation that is allowed under the post 1988 rules. In this example, the depreciation taken before 1988 is $8,000, so the adjustment is $4,000, which is subtracted from the farming income from the quota sale.

Transfers While Alive

Quota can be transferred to a child on a completely tax deferred basis or at any price up to FMV. The tax deferred price is based on the following formula *(4/3 × CEC) + 1971 Value*, where the CEC is the cumulative eligible capital account and the 1971 value is the FMV quota holdings as of Dec 31st 1971. This amount

would represent the highest price that would trigger no income. A sale between this value and FMV would trigger some gain and possibly recapture.

On the child's side there are potential reductions to the amount of the quota that can be added to the CEC and thus available for depreciation. These are:

1. The 1971 values deducted by the parent reduce the deemed cost to the child.

2. If the parent used their capital gains exemption then the amount added to the child's CEC account is reduced by an amount equal to two times the capital gains deduction that was claimed by the parent.

3. Even where the capital gains deduction is not used or only partially used, the amount that can be added to the CEC account is restricted by the non-taxable portion of the capital gain. One half the difference between the taxable capital gain and any capital gain deduction claimed further reduces the amount of the addition to the cumulative eligible capital account.

These deductions are only relevant for determining the amounts allowed for additions to the cumulative eligible capital account. They do not affect the cost used for determining future capital gains.

Table 7 illustrates the results of some alternative family sale prices. The examples assume that all quota was purchased after 1971 and thus the 1971 value deduction is zero. The FMV is $600,000. The current CEC balance is $50,000 and $40,000 of depreciation has previously been taken, one half before 1988 and one half after 1987. The parent claims a capital gain exemption.

There is no Alternative Minimum Tax calculation on quota if the election described above has not been taken.

Transfers on Death

On death there is no opportunity to elect out of the rollover provisions.[18] While this means that the transfer takes place on a tax-deferred basis, it also means that on the final tax return the quota value cannot be bumped up to create a capital gain and utilize the parents' capital gain exemption.

A rollover of quota is allowed to any beneficiary, not just children. The quota is deemed to transfer at four-thirds (4/3) of the undepreciated balance of the cumulative eligible capital account (CEC). This results in no income to the deceased person with the beneficiary taking the deceased person's place for future tax calculations.

Table 7. Alternative Transfer Prices for Quota (Post 1971)

Various Family Sale Prices	Deemed Proceeds	3/4 Deemed Proceeds	(Deemed Proceeds Less CEC)	Re-capture	Farming Income Eligible for Capital Gain Exemption	Deemed Cost to Child
$600,000	$600,000	$450,000	$400,000	$40,000	$233,333[1]	$133,334[2]
300,000	300,000	225,000	175,000	40,000	83,333	133,334
0	66,666	50,000	0	0	0	66,666

1 Deemed taxable capital gain = $400,000 – ($40,000 recapture) – (1/2 of $20,000 pre 88 depreciation) = $350,000. Then use a 2/3 adjustment for the 50% inclusion rate, which equals $233,333.

2 If the parent uses the capital gains exemption the child's tax cost is reduced by 2 times the taxable gain. In the first example this would be 2 × $233,333 = $466,666. This would reduce the child's cost from $600,000 to $133,334 (600,000 – 466,666).

Table 8. Alternative Transfer Price for Land

Today's FMV ($)	Various Family Sale Prices ($)	ACB ($)	Deemed Proceeds to the Parent(s) & cost to the child ($)	Capital Gain ($)
600,000	600,000	100,000	600,000	500,000
600,000	300,000	100,000	300,000	200,000
600,000	100,000	100,000	100,000	0
600,000	0	100,000	100,000	0

Table 9. Transfer of Partnership Interest or Corporation Shares

FMV ($)	ACB ($)	Various Sale Prices to Child ($)	Deemed Proceeds and Cost ($)	Capital Gain ($)
$800,000	$200,000	$800,000	$800,000	$600,000
800,000	200,000	400,000	400,000	200,000
800,000	200,000	200,000	200,000	0
800,000	200,000	100,000	200,000	0

LAND – CAPITAL PROPERTY

Transfers While Alive

Farmland can be transferred at any value between ACB and FMV, both before and after death. Because land usually appreciates in value parents often want to use their $750,000 capital gain exemption on the transfer. This strategy also benefits the child by giving them a higher ACB from which future capital gains are calculated.

In order to trigger a capital gain a sale must occur. Since children often cannot afford the full FMV, one option is for the parent to sell the property at the FMV and hold a mortgage or note on the property. On death the outstanding debt is forgiven in the will. Forgiveness of debt outside of the will can have negative tax consequences and should be avoided.

Table 8 illustrates the results of different family sale prices.

Transfers on Death

On death farmland can be transferred on a rollover basis and all tax deferred, or at any price up to FMV. If the deceased parent has any capital gains exemption available, the transfer can take place at any value between the ACB and FMV in order to incur some capital gain and provide the child with a higher ACB. The alternative minimum tax (AMT) does not apply in the year of death.

LAND TRANSFER TAX

Land transfer tax is a tax levied by Ontario on the transfer of land that includes any buildings. Land transfer tax is normally based on the amount paid for the land, in addition to the amount remaining on any mortgage or debt assumed as part of the arrangement to buy the land.

The tax is levied on the consideration received and therefore gifts of land are not taxable. The tax rate is graduated, based on the transfer value. The example in *Table 10* shows that the land transfer tax on a property transferred for $800,000 would be $10,475.

Table 10. Land Transfer Tax on Land

Transfer Value = $800,000

Value Ranges	Tax Rate (%)	Taxable Amount ($)	Tax ($)
Tax on the first $55,000	0.5	55,000	275
$55,000 to $250,000	1.0	195,000	1,950
Tax above $250,000	1.5	550,000	8,250
Land Transfer Tax			**$10,475**

Several exemptions from the land transfer tax are allowed on the transfer of farmed land to related individuals. To qualify the land must be used predominantly in farming by the individual or the related individuals prior to the transfer. The land must also be farmed by those family members after the transfer.[19] The exemptions are:

- farmed land transferred to a related individual(s), which includes a spouse, child, grandchild, siblings, cousins, aunts and uncles and those related by marriage
- farmed land transferred from the estate of a deceased individual to an individual(s) who would have qualified for the exemption had it been made by the deceased individual before his or her death
- farmed land transferred to a family farm corporation
- farmed land transferred from a family farm corporation to a related individual(s)

There are circumstances where the exemption will not apply because the specific requirements for exemption have not been met. The exemption will not apply where:

- the transfer is part of an arrangement to sell the shares of the transferee corporation to a third party
- the transferee corporation does not continue the farming operation, but instead acts as a holding corporation, renting the land to the operating company. The transferee corporation must be the corporation that actually farms the land

- where the transfer is to a related individual whose corporation farms the land. In this case the individual leases the land to his corporation and therefore does not farm the land himself

FARM FAMILY PARTNERSHIPS AND CORPORATIONS

Transfers While Alive

The *Income Tax Act* also provides for the deferral of tax on the transfer of an interest in a family farm partnership and shares in a family farm corporation. Both of these structures are defined in the *Act*.[20] In order for the rollover provisions to apply the partnership or corporation must meet the specific requirements outlined in the *Act*. These are complex; contact your tax advisor well in advance of any planned transfer since adjustments can be made to bring a partnership or corporation in line with the definitions (which are a requirement for the rollover treatment), but this must be done in advance of any transfer.

Like land, an interest in a family farm partnership and shares in a family farm corporation can be transferred at any value between ACB and FMV. This can occur either before or after death. Any capital gain generated can be offset by any available capital gains exemption.

Table 9 illustrates the results of alternative transfer prices. When the capital gain exemption is available it can be beneficial to sell an interest or shares at close to FMV to take advantage of the capital gains exemption and have a higher ACB for the child. This higher ACB would only be an advantage if the child sold the shares and not the individual assets. The alternative minimum tax may be a factor in some cases. For more information on partnerships and corporations see OMAFRA factsheets *Farm Corporations*, Order No. 01-057 and *Farm Partnerships*, Order No. 02-047.

Transfers on Death

On death an interest in a family farm partnership and shares in a family farm corporation can be transferred at any value between ACB and FMV. The legal representative of the deceased may elect between the ACB and FMV in order to incur some gains and provide the child with a higher ACB at no tax cost to the estate if the $750,000 exemption remains. The alternative minimum tax (AMT) does not apply in the year of death.

FARM BUSINESS TRANSFER EXAMPLE

From the above discussion, it is clear various values can be used depending on the needs and desires of the family. Capital gains can be deferred or triggered, recapture deferred or the farm business transferred at a price the child can afford. While there is no single strategy, there are general approaches.

A common strategy might be:

- transfer land between ACB and FMV. If the capital gains exemption is available the price is usually closer to the FMV
- quota is transferred at a value that does not create any recapture or gain if no exemption is available. If capital gain exemption is available then a higher value might be used
- depreciable assets purchased before 1972 (Part XVII) are transferred at fair market value or as a gift
- personal residence is transferred at fair market value or as a gift
- depreciable assets purchased after 1971 (Part XI) are transferred at or near undepreciated capital cost (UCC)

The highest transfer price that allows maximum deferrals is the combination of land at ACB, quota at (4/3 × CEC) – 1971 Value, Part XI assets at UCC, Part XVII assets at FMV and personal residence at FMV.

Tables 11 and *12* outline two transfer scenarios. *Table 11* show a transfer at FMV with the use of the $750,000 capital gains exemption and no deferral of inventory income. *Table 12* shows a transfer that minimizes tax and uses almost all the capital gains exemption by setting the price of the land at FMV. The quota price was not increased because of the fact that recapture would be generated. Of course a price between these scenarios could be chosen but taxable income would be generated.

Table 11. Transfer at Fair Market Value (FMV)

Assets	ACB	(UCC or CEC)[1]	Transfer Value at FMV	Capital Gain	Recapture and Income	Taxable Capital Gains
Land	200,000	—	900,000	700,000		350,000
Quota [2]	—	100,000	700,000	375,000[2]	50,000	250,000
Buildings (Pt.XI)	140,000	100,000	200,000	60,000	40,000	30,000
Machinery (Pt.XI)	100,000	50,000	150,000	50,000	50,000	25,000
Inventory	—	—	200,000	—	200,000	—
House	60,000	—	150,000	90,000	—	—
Total			$2,300,000	$1,275,000	$340,000	$655,000
Capital Gains Exemption Available		$750,000	Capital Gains Deduction (deduct from TCG)			$375,000
Total Taxable Capital Gains						$280,000
Total Income on which tax paid ($340k + $280K)						$620,000
Total tax payable based on highest marginal rate of 46.41%						$287,742

1 UCC is the undepreciated capital cost and CEC is the cumulative eligible capital.

2 The calculation for the deemed taxable capital gain on quota is more complex than just taking 50% of the increase in value, as is the case with an asset such as land. The calculation for quota is based on $50,000 post 1988 depreciation, 1971 value of $0, and a CEC of $100,000.

Table 12. Transfer at Tax Cost, Land at Fair Market Value, Note for Inventory to Defer Income

Assets	ACB	(UCC or CEC)	Transfer Value	Capital Gain	Recapture and Income	Taxable Capital Gains
Land	200,000	—	900,000	700,000		350,000
Quota	—	100,000	133,333	—	—	—
Buildings (Pt.XI)	140,000	100,000	100,000	—	—	—
Machinery (Pt.XI)	100,000	50,000	50,000	—	—	—
Inventory	—	—	Promissory note	—	—	
House	60,000	—	150,000	90,000	—	—
Total			$1,333,333	$790,000	$ —	$350,000
Capital Gains Exemption Available		$750,000	Capital Gains Deduction (deduct from TCG)			$375,000
Total Taxable Capital Gains						$ —
Total Income on which tax paid						$ —
Total tax payable based on highest marginal rate of 46.41 %						$ —

SECTION 8 — RESERVES AND FORGIVENESS OF DEBT

CAPITAL GAINS RESERVES

What is a reserve?

A reserve allows for a deferral in reporting either business income or taxable capital gains. It is allowed when all or part of the proceeds of the sale are not payable until after the end of the year in which the property is sold. A reserve is also available for quota, provided an election under section 14(1.01) of the *Act* is made.

Usually a mortgage or a note is sufficient evidence that an amount remains outstanding. However, a promissory note without restrictions as to when payment can be demanded represents "absolute payment" of the debt and in such a case, a reserve will not be allowed. The note should contain restrictions, such as payable 366 days after demand, to ensure that a reserve can be used.

A five-year reserve is allowed on dispositions to unrelated parties. A minimum of at least 20 per cent of the gain must be brought into income each year.

A 10-year reserve is allowed on the disposition of land, depreciable property or a share in a family farm corporation or an interest in a family farm partnership to a child. Accordingly, a minimum of 10 per cent of the gain must be brought into income each year.[21]

A reserve is not available to an individual who transfers property to a corporation that they control or did control or to a partnership in which they hold a majority interest.[22] A reserve is not available in the year of death.[23]

Why use a reserve?

There are several circumstances where a reserve might be useful. Firstly, if a large capital gain has been triggered, alternative minimum tax (AMT) may be payable even though the capital gains exemption is used. The use of a reserve could spread the gain over a number of years, reducing the possibility of paying AMT. As the capital gain is removed from the reserve, the capital gains exemption can be used.

The second circumstance is where the capital gains exemption is not available or has been fully used. Spreading the taxable capital gain over a number of taxation years may prevent income levels from reaching the higher tax brackets. It may also reduce the claw back of benefits and the possible application of the AMT.

How is it calculated?

The amount available for a reserve is the lesser of two amounts:

- four-fifths of the gain in the year of sale (three-fifths, two-fifths, and one-fifth in years two, three and four)
- amount payable at the end of the year divided by proceeds of the sale, multiplied by the capital gain

FORGIVENESS OF DEBT[24]

Forgiving the debt of a child while alive by way of a gift that reduces a note or mortgage, or any other indebtedness can result in negative tax consequences for the recipient. The results could include reductions in farm losses, net capital losses and restricted farm losses. If none of these are available for reduction then the ACB of the capital asset is reduced or 50 per cent of the forgiven amount can be included in the income of the debtor. If a parent wants to gift money to a child while they are alive they should consult with their accountant about the best way to do that. Simply writing off of debt or an exchange of cheques should be avoided.

Forgiveness of debt in a will (by bequest) on the other hand does not have any of the negative tax consequences mentioned above. For example a parent might sell a piece of property to a child at FMV to trigger a capital gain which is offset by their capital gains exemption. The child may pay a portion of the debt while his parents remain alive and then the remaining amount is forgiven in the parent's will.

SECTION 9 — ALTERNATIVE MINIMUM TAX (AMT)

Alternative Minimum Tax[25] (AMT) is a tax on dividends from Canadian corporations and capital gains. The AMT calculation is an alternative calculation of taxable income that includes the non-taxable part of the capital gain. The calculation shown in *Table 13* uses the approach outlined in the *Act*, which includes a four-fifths (80 per cent) downward adjustment of the capital gain followed by the deduction of the taxable capital gain. A simplified approach is to include 30 per cent for the entire gain (30 per cent × $500,000 = $150,000).

The AMT allows an exemption of $40,000, which means that the AMT has no effect until a gain of more than $133,333 is realized (the $133,333 times 4/5 equals $106,666, which equals a taxable capital gain of $66,666 (133,000 × 0.5) which when subtracted leaves $40,000, which is the amount of the exemption).

This amount can also be higher when the personal credits are used in the calculation. This alternative calculation is then compared to the regular tax calculation and, if it is higher, the additional amount is payable.

Any minimum tax paid can be carried forward up to seven years, and used as a credit against tax payable in those years.

Ontario also has an AMT, which is 40.33 per cent of the basic federal tax calculated under the AMT calculation.

Table 13. Alternative Minimum Tax Calculation

	Regular Tax Calculation ($)	Minimum Tax Calculation ($)
Capital gain	750,000	
Taxable capital gain – 50%	375,000	
Amount of gain for AMT (0.80 × 750,000)		600,000 [1]
Income included after capital gains exemption used	0	
Untaxed capital gain (600,000 – 375,000)	0	225,000
Plus farm income	50,000	50,000
Minus minimum tax exemption		40,000
Approx. taxable income	47,951	235,000
Approx. federal tax payable [2]	6,150	33,195
Approx. provincial tax payable [3]	2,621	18,382
Total federal and provincial tax [4]	8,771	51,577
Additional minimum tax payable		42,806

1 The calculation for the alternative minimum tax adjusts the capital gain downward by multiplying the gain by 0.80. This is done because of the capital gain inclusion rate change from 75% to 50%. (30% of the total gain of 750k can be used to arrive at the untaxed capital gain upon which the AMT is applied)

2 To calculate the regular tax payable, the 2008 federal tax rates were used. Federal tax rates are 15% on the first $37,885 and 22% on income between $37,886 and $75,769. A flat rate of 15% is used to calculate the federal minimum tax payable.

3 To calculate the regular taxes payable 2008 provincial tax rates were used. Provincial tax rates are 6.05% on the first $36,020 and 9.15% on income between $36,021 and $72,041. Ontario surtaxes of $4,854 were added. A flat tax rate of 40.33% of the federal minimum tax less the federal tax of $6,150 is used to calculate the provincial minimum tax ((33,195–6,150) × 40.33%). This is then added to the regular provincial tax to obtain the total for the minimum tax calculation.

4 This tax calculation included federal and provincial basic personal tax credits and the CPP tax credit. CPP payments and the Ontario health tax were not included.

This Factsheet is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of transferring farm assets, it should not be considered as either an interpretation or complete coverage of the *Income Tax Act* or the various laws affecting family transfers. The Government of Ontario assumes no responsibility towards persons using it as such.

Discuss all asset sales or transfers with your accountant and lawyer before they are undertaken.

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1 *Income Tax Act*, Section 69
2 *Income Tax Act* Subsection 70(10) and 252(1)
3 *Income Tax Act* Subsections 70(9) & 73(3)
4 *Income Tax Act* Subsection 70(9.6)
5 *Income Tax Act*, Subsection 110.6(2)
6 *Income Tax Act*, Subsection 110.6(1)
7 *Income Tax Act*, Subsection 110.6(1.3)
8 Definition of capital property found in *Income Tax Act* Section 54
9 *Income Tax Act* Subsection 24(2)
10 *Income Tax Act* Sections 74.1 and 74.5
11 Interpretation Bulletin IT – 427R – Livestock of Farmers, Canada Revenue Agency
12 Interpretation Bulletin IT – 212R3 and 212R3SR – Income of Deceased Persons – Rights and Things, Canada Revenue Agency
13 *Income Tax Act* Subsection 70(2)
14 *Income Tax Act* Subsection 70(3)
15 *Income Tax Act* Paragraph 13(7)(e)
16 Interpretation Bulletin IT-268R4 - Inter Vivos Transfer of Farm Property to Child, Canada Revenue Agency
17 *Income Tax Act*, Subsection 14(1.01)
18 *Income Tax Act* Subsection 70(5.1)
19 Ontario Ministry of Revenue Tax Bulletin LTT 3-2008
20 *Income Tax Act*, Subsection 70(10)
21 *Income Tax Act*, Subsection 40(1.1)
22 *Income Tax Act*, Subparagraph 40(2)(a)(ii)
23 *Income Tax Act*, Paragraph 72(1)(c)
24 *Income Tax Act*, Section 80
25 *Income Tax Act*, Section 127.5

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